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Tax Reform: What are the Options?

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[Intro]

Welcome to the IWU Roundtable, one of the series of public dialogues sponsored by the faculty at Illinois Wesleyan University. Each roundtable features extended deliberation on an issue of public concern. Today's discussion is, *Tax Policy: What are the Options?* This IWU Roundtable uses the claim-objection-rejoinder format to assess the strength and weakness policy reforms currently before the public. By modeling this liberal arts format, the discussion aims to help citizens understand the principles, values, and tradeoffs at stake in our tax policy debate.

[Jim]

Welcome to the IWU Roundtable! Today's session is titled, *Tax Reform: What are the Options?* I'm Jim Simeone, Associate Professor of Political Science and I'm joined by two colleagues.

[Ruth]

Hello, I'm Ruth Ann Friedburg, Associate Professor of Accounting.

[Diego]

Hi, I'm Diego Mendez-Carbajo, Assistant Professor of Economics.

[Jim]

Ok, well thank you all for coming and agreeing to be our guinea pigs [short laughter], as we lay out a new format. We're still experimenting with this format and just to let you know, we see ourselves as citizen scholars, none of us have a special expertise in tax policy, but we've boned up on the matter and we have a program for you today. The idea is we're trying to model what public deliberation might look like if it were done right and I don't know if we've succeeded, but you can help us. The other reason we have all these microphones is that we'll be recording some of this and we might want to put together CD's eventually, so your questions might actually appear on our format.

Ok, so tax policy is a broad issue. We've divided it into three types of taxation with three criteria that we'll use to evaluate. We're going to look at the income tax, we're going to look at the consumption tax and the state or welfare tax and the three criteria we'll use are efficiency, fairness, and practicability. Ok, currently the income tax accounts for 37% of the federal government's overall revenue, which amounts to about a trillion dollars, and we will be looking at the flat tax and the consumption tax from the perspective of a revenue neutral perspective, that is we'll assume if the flat tax or the consumption tax replaces the current income tax, it would also have to raise 37% of the government's revenue, or about one trillion dollars. The reason we chose the flat tax is because a number of people have been debating it over the years. The consumption tax has recently been endorsed by Allan Greenspan, so we thought we'd throw that in there. And, of course, the state tax, which only raises 1% of the U.S. revenue, is about twenty-one billion dollars, is being debated currently in the U.S. Senate. The U.S. House in March of last year passed a law, creating an elimination of the tax starting in 2011, so we decided to throw that in there as well.

Ok, Diego will start talking about the income tax, I'll provide some information about the progressive income tax in response, and then we'll move to discuss the consumption tax.

[Diego]

Ok, I will begin with a brief on flat income tax. I have to say that although I don't talk about the flat income tax in my classes, precisely this week my students are going to be exposed to a midterm exam on this material [short laughter] Thursday, so I've been brushing up on my taxation theory [laughter]. I will begin by saying that a flat income tax has several positive qualities, mainly and this is the most important argument for a flat income tax, it creates the least market distortion and thus is less inefficient than the current personal income tax. What do we mean by inefficiency in economics? Inefficiency means that every single tax that exists creates a sort of market distortion because we have to pay taxes when we purchase certain goods or services; our demand for those goods and services is affected. A very dramatic example is the imposition of import tariffs. So people want to tax certain foreign goods, so they don't get imported into the country, we impose these excessively large taxes. Well, the distortion effect of an import tariff is that it drives our demand for one particular good to zero; it eliminates the demand for that good. Any single tax does the exact same thing for us. In the case of personal income tax, the tax is created. Now, distortion in our decision between how much time we're going to put to work and how much time we're going to put to leisure, either the income tax is too steep, that's going to give us a disincentive to work additional hours, collect additional pay, and get tax with additional dollars. Alright, so with a flat income tax what we're trying to avoid is that distortion effect. Having a flat marginal rate will give people an incentive or less of a disincentive to substitute unpaid leisure for paid work. Proponents of the flat tax will also argue that it will be a more efficient revenue collection tool because a flat tax reduces the incentive to cheat, number one, because it decreases the benefits from evasion. You have, because you're taxed somehow less with the progressive income tax, you have less of a gain to achieve if you avoid the taxes. At the same time, the costs of cheating are exactly the same. If you get caught, you're going to get fined and you're going to get thrown in jail, therefore the cost of the analyses, and lately we've seen some of that [laughter]. So the cost benefit analysis on the flat tax supports much more to pay the tax than evading the tax.

Just a brief aside, every single tax creates an excess burden and the only type of tax that doesn't do this, is what we call in economics lump sum tax, a tax that everybody has to pay, a fixed amount of money that everybody has to pay, regardless of their condition, regardless of their income, regardless of their status. As you can imagine, this is a very efficient tax, but it's not a very politically popular type of tax. The only time that such a tax has been implemented in recent history was in Great Britain in the 1990's when Margaret Thatcher imposed this poll tax where everybody will have to pay, the amount of the tax [which] was a function of the revenue that each city had to collect. That was a political disaster, it cost Margaret Thatcher her position in the British government and the moment John Major was the Prime Minister the tax repelled. So, we're talking about tax policy reform, my argument will be that this element of efficiency, this element of excess burden that a tax imposes on people is a critical aspect to look at.

[Jim]

Okay, I give the objection here. I think this issue of deadweight loss or excess burden is an important one, although it's very abstract and hard for us to get a handle on. Don and I were talking earlier and said that economics is the dismal science and it's dismal because it's so arcane and abstract. If I could put a concrete example forward to help elucidate this notion of deadweight loss it would be something like when you are taxed one dollar and the government spends that dollar to build a bridge, then you don't see any dead-weight loss there because you see the benefit. But, in the case of the distorting effect of taxation, where people are foregoing certain choices that they would have done otherwise, you do have a loss, such that, you could say the one dollar was never generated and therefore it's gone to us.

Ok, that problem of distortion is a serious problem and if the flat tax could claim to overcome it, then I think it would have something very strong in its favor. And I'm suggesting that since a lot of people really don't think about the distortion effects, it's probably a tough row to hoe because the flat tax, no one really tries to understand what they're trying to overcome. But it's not clear to me that the flat tax does in fact overcome the distortion effect, I think it requires that we define business expenses very strictly, and that would be a problem. The other problem might be that in order for these rates to be low enough, not to have a disincentive to cheat, you wonder, I think Rosen gives the number of 17% as a flat rate that everyone would have to pay on their taxable income and it's not clear to me that that would raise enough revenue and so there's this tension between lowering the rate enough to make it acceptable for all to pay without distortion, but at the same time wondering whether you'd get enough to raise the revenue. But, my central objection to the flat tax comes on fairness grounds, using the fairness criterion. The flat tax claims to equal treatment, but isn't really equal. I argue that the key to equal treatment is the key to equal sacrifice. I'm going to talk about this concept of equal sacrifice, which is not the same thing as paying the same rate or a same dollar amount.

Progressive taxation, the common alternative to flat rate taxation could be defended precisely on the ground that it is fair to the individual because it inflicts a similar level of pain or sacrifice from each citizen. Progressivity may be defined as requiring individuals with different taxable income levels to pay a different marginal tax rates. So, right now the tax rate of 7% is paid until the first ten thousand dollars of your taxable income and then it goes up progressively to 35% at three hundred and twenty-five thousand dollars of taxable income. Ok, so there are different rates for different people and the question is, well wait if there are different rates, that's unfair, that's not equal treatment. The argument is, from a progressive standpoint, that it is equal treatment in the sense that it exacts equal sacrifice. So, how does this claim made good? The claim that progressive marginal rates like these inflicted equal sacrifice rests on the assumption that the value of money diminishes at the margins, or as the economists would say, it rests on the assumption that there is a downward sloping demand curve for all commodities, even money. Now what does this mean? The idea is that money, like any other commodity, declines in value at the margins, which means that each additional dollar has a little less utility to its owner than the previous one. Thus, the value of an additional value to a millionaire is marginally less than the value of an additional dollar to a person making, say thirty thousand dollars a year. So if the state taxes the millionaire at a 35% rate, takes thirty-five cents of that million and first dollar, and taxes the person making thirty thousand at an 18% rate, takes eighteen cents of the thirty thousand and first dollar, then assuming a certain diminishing rate of utility, the state exacts a relatively more equal sacrifice from the two individuals than if it takes eighteen or thirty-five cents from both. The flat tax claims to be about equal treatment but if we understand equality in terms of sacrifice or burden, then the flat tax misses the mark badly.

[Ruth]

Diego, I agree with Jim that fairness is definitely an issue in discussing flat tax, in fact, the flat tax proposals that were popularized by the presidential candidates, Steve Forbes and Jack Kemp were basically another wage tax. These proposals only taxed wages, they didn't tax interest dividends or capital gains, so therefore, and basically it would have been the working class that would have been hit with these taxes. And although I don't have it in my notes, I would also point out that we have a very political system that creates our tax base and when people start finding out that they're under these flat tax proposals, their mortgage interest is not going to be deductible, the charitable contributions are not going to be deductible, they're going to be unhappy and of course the lobbyists for all of these groups are also going to be very very unhappy. So one of the basic problems here is that we're really not going to get the simplicity that we want because I think if we learned anything over the last twenty years, is that the government responds to the lobbyists and the government responds to the people – in other words, when they get angry.

So the proposal, giving everything else, is just unlikely to get going. In fact, Forbes and Kemp did not climb in the political process, partly because people started out finding more about those flat tax proposals and they didn't like them. So in the end they tried to dole on Bush, who were basically looking for tax reform but not going towards that flat tax process. The working class would be paying more under the flat tax than they would under an even moderately progressive tax. The complexities of the current income tax have little to do with the progressive rate structure. The complexities of our current system have nothing to do with the fact that this is progressive, it has to do with some of the other issues that I brought up about all of the special interests, all the laws that have been created because people are trying to create loopholes, basically for paying tax.

My solution to the problem is the consumption or spending tax as an alternative to the income tax. We've already said that the tax should be simple, efficient and fair. I would add that a fair tax would create little or no effect on economic decisions, including work, spending and investment decisions. And those issues have been brought up, about the importance of not changing the dynamics there. The income tax has been proven to be complex, inefficient, and not fair. All attempts to solve the underlying problems with the income tax have failed. In fact, the Tax Act of 1986, which was really in response to the flat tax proposals, where they reduced the progressive rates and became much flatter. In other words, they lowered them and reduced the number of levels of that and that has failed miserably. The Tax Reform Act of 1986 has not been successful.

My proposal would abandon the income tax and any alternative options that use income as the taxable base and consider a consumption tax. Now let me just say that the consumption tax has been around for a long time, or the concept of a consumption tax has been around ever since it was first introduced in 1913. Of course at that time they were raising a lot less money so they chose to go with the income tax. Maybe when they chose they felt it would be easier at that time. Where in 1977, the Treasury Department did a comprehensive study and presented information on what a consumption tax would look like. And what I wanted to do now is kind of give you an idea of what this tax is and how it would work. And I will say that I got a lot of my information from this book called, *Fair Not Flat*, that was written by Edward McCaffrey, who is a Harvard law graduate and he works in a business school in southern California where he is a professor. I tried it and found it extremely readable, very interesting and I have been interested in the interest tax ever since I was in grad school and did a project on it, and I've found it to be very intriguing. A consumption tax has all sorts of names and all sorts of processes. It could be a national sales tax, it could be a value added tax, and if anyone has traveled, they have probably experienced the value added tax, and a personal expenditure tax, it can be any one of those three or a combination of those three.

The national retail sales tax in the VAT are similar in that they both tax money as it is spent. In fact we currently have a limited national sales tax, it's called the excise tax. So many of you might be familiar with at least the name of the excise tax. The excise tax targets products such as alcohol and tobacco. SO when the government is especially for obviously those two, they're trying to control the use of both alcohol and tobacco. And so the alcohol excise tax is one way doing that. And that would tie in with what we said: it changes behavior (laughter). If in fact, you hear more recently, especially with tobacco you hear some people say when they raise the price again, you know it just became too much. And that of course, the prices are going up more because of the taxes, not for any other reason.

The essential difference between the sales tax, the national sales tax and the VAT is the difference is when the tax is collected. The VAT is calculated and collected as the product is manufactured and produced. While a national sales tax is collected at the retail transaction. And again, what you would have experienced when you traveled is the VAT and that simply means every time when a product is in the production stage and value is added to that product, a tax is assessed on the additional value. Of course the way that countries have worked this, if you travel to a country and spend enough, then you can get a refund of that value added tax because that tax is intended for the citizens of a country, not for the visitors to that country. So they also have it set up as if those countries export the products say to the United States, the importers do not pay that value added tax, it is a national tax. Of course in Europe, the problem is now with the European Union, if you're a member of the European Union, you pay the tax regardless.

Although the national sales tax and the VAT would be efficient to administer, these taxes are inherently aggressive. Lower income families require to pay a larger percentage of their income in taxes because they spend a larger part of their income on necessities. Giving a specified rebate for a portion of the tax to all taxpayers or giving the rebate to the lowest wage earners could minimize this problem. Other problems with these taxes include the potential for black-market activity, the temptation to exempt many items consid the necessities of life, and the difficulty of including personal services that make up a large share of the national economy. The more items that are excluded from the tax, the higher the tax must be on the remaining items in order to collect the required revenue. And then we get back to what

Diego was talking about, is it has an effect on decisions, and the fact that there would be some products that perhaps would have to be taxed so high that they might actually no longer be available because the manufacturers couldn't continue to produce them.

Virtually every country that has tried a national sales tax is reverted to the VAT. So of the two, the VAT does seem to be a more reasonable or the countries have found it easier to, I think, probably administrate than the national sales tax. We should know, however, that although many countries have implemented the VAT, in all cases the tax is a supplement to and not a replacement for the income tax. So when we hear them talking about the VAT, don't assume that that means they're going to eliminate the income tax because it just hasn't happened, they have not been able, obviously, to replace everything with that VAT.

In the most basic form, and now we want to get to what I really like, which is the consumption tax/the spending tax, the personal expenditure tax imposes a tax on all expenditures. Using the basic definition of income first proposed by Robert Haig-Simons, we arrive at, basically I've changed their equation a little bit, consumption equals income minus savings. So basically if you think of income, your basic cash inflow, you have inflow from your wages, you have income from savings, you have income from dividends, you have income from assets, gains that have from assets that have been sold – that's you cash inflow. Obviously a lot of people when they have cash inflow, they immediately put it back. A lot of people will sell one investment and purchase another investment. So the consumption, which you're looking at is basically the net difference. What kind of cash flow have you gotten in and how have your, basically, investments changed? If you've gotten income and you've reinvested it, then you haven't consumed it, so then it wouldn't be taxed. So you're only going to tax income as you consume it, as you spend it. The consumption is not investment. Consumption is purchasing personal services, purchasing assets, etc. I'm not going to go into all of the complexities, but it is actually very easy. The beauty of this is that one of the most complicated areas of our tax system, the area that has been changed the most over the years is capital gains, the problem with capital gains. They tried to solve it by reducing the rates, and if you ever look at how those rates have gone up and down over the last four years, it's just absolutely incredible to solve that problem.

Here you don't have the problem. If you sell an asset for $10,000, even if you had an $8,000 gain, if you reinvest that $10,000 in another asset, there is no tax because there has been no consumption. So, it just basically eliminates it. If you sell that $10,000 because you want to take that asset for $10,000, because you want to take a cruise around the world, you consumed it and at that time it would become taxable. You have those choices to make with the consumption tax.

Although many variations of a personal expenditure tax have been put forward, any viable proposal must address the major problems with the current income tax. The income tax in its current form is essentially a wage tax, and let me explain more why I say that. It is because wealthy individuals have been able to structure cash flow in such a way that can be totally tax-free. The individual who works hard and receives a W-2 cannot avoid the tax on earnings. That W-2 statement goes to the government goes on your tax return, and your ability to control that is very difficult once it gets on your tax returned. In other words your method of hiding it is just not there (laughter). The tax system taxes on income and savings, interest and dividends, but does not tax unrealized growth on investments, and that's the trick here is for the wealthy individuals. Wealthy individuals are in a superior position to take advantage of the situation. The way McCaffery explains it, if you have enough money and you have that with investments, what can be done is you basically borrow on your investments. You borrow on your investments, borrowed money is not taxed, you can live quite a luxurious life, and I'm not going to get into the details, the money that remains in your investment grows and theoretically it can grow as fast as the cost of the money that you borrowed, and hopefully it grows at a rate faster than the money you borrowed, so your wealth is increasing and at the same time, you're living basically tax-free. I don't know if anyone in the room is in this position (laughter), I doubt if there are any, it's a very small percentage but most of us could never attain that position, that we would be able to do that.

However, when appreciated investments are sold, there are tax consequences, this situation negatively affects investment decisions. Another major problem is the borrowed fund is not taxed, this is what I explained before. This enables wealthy individuals to live off of borrowed funds, while keeping their investments in tact. A personal expenditure tax can address all these problems. Using a model that I found in the back that I showed before, it's called, the "Progressive Spending Tax", and can not only replace the income tax, but the gift in the state tax that Jim is going to talk about, and it can do so in a fair and equitable way. Cash flow is the essential feature, and as I said before, you add up all of your cash inflow, which would be wages, loans, savings and investments, and reduce this by any monies that have been put back into savings and investments. The difference represents the individual's consumption for the period, interest in dividends would be included, would not be included unless they were withdrawn, in other words, if they were allowed to accrue in the accounts, they wouldn't be taxed.

The proceeds from sales of investments were reinvested; they would not be considered consumption. Thus, the entire issue of capital gains would be eliminated, also preference for particular types of savings, such as IRAs and medical savings accounts, are no longer necessary because all savings are automatically exempt. So basically, you have an infinite IRA out there, you can put anything you want and as much as you want into an IRA and it will not be taxed until you consume it. The taxable consumption computed above can then be reduced by any deductions that are determined to be fair, such as medical expenses, charitable contributions, and homeworker's interest. So, you can put back in there, in other words, if you consume for those items, you could also exempt those from the consumption tax. Progressive rates can then be applied to the resulting, yet taxable consumption. With this approach we can eliminate all the tax rules pertaining to pension plans, capital gains, tax-free municipals, etc. There would be an added incentive to save, in order to differ the tax. According to McCaffery, dead people do not spend so there should not be an estate tax (brief laughter). As for gifts, no tax consequences to the donor, and the donee would only pay the state tax when the gift was consumed, and these would be gifts of cash actually. If the donor purchased something of value, a gift for someone, then that wasn't in cash or investments, then that would be considered consumption because I guess then we get into the pleasure derived from giving the gift.

[Diego]

My objections to refunds are basically on the grounds of practicality. I'm originally from Spain. Spain has a VAT tax, one of my brothers, a lawyer, that actually makes a lot of living helping people how to pay the VAT tax because it's a fairly complicated tax to clear. I appreciate the VAT because I can get my shoes when I get back to Spain for Christmas, I can buy shoes and get the tax back when I leave the country (laughter). In May term I was teaching a course on European Economic Integration and we were talking about how the VAT in the European Union might go from something like 15% in a country like Portugal to 25% in central Europe and northern Europe. So the range of tax rates that would be necessary under the VAT tax to collect any amount of meaningful revenue are all over the place. So 7.5% seems steep, 17% or 24% is automatic. A similar practicality argument can be levied against the consumption tax. If we're going to be exempting certain types of consumption, if people are going to need to plan ahead for the tax that they're going to be paying based on their future consumption, we have to question how practical, how realistic it is for people to be able to have that long term horizon view of their life, and plan that consumption taxation accordingly. I don't think I would be able to do it, but maybe I need some training (laughter).

Practicality is also an important similar deficiency, it's also important to figure out what kind of taxes we should use, the kind of taxes we should have. The issue of practicality is also critical. I'm going to be quoting Harvey Rosen's textbook, *Public Finance*, for all my figures here and I will let you know that administering the income tax in the United States is a fairly cheap proposition. It estimates a range from 39 cents cost for every $100 collected in personal income tax, it seems to be quite a bargain. Nonetheless, there are a number of costs that are not capturing that 39 cents per $100, those are the administering costs for the IRS. Some of us have to hire accountants in the past to look at our tax, some of us have to hire lawyers to organize our stakes, and we also throw in the number of hours it takes to figure out how to pay the taxes after liquid taxes. In 2000, the estimate is that the U.S. economy spent $115 billion on paying taxes, not on the cost of taxes, but on the cost of liquidating, figuring how to pay taxes, and actually turning the tax declarations in.

There's no doubt that the choice of tax that we're discussing here needs to be taken into consideration how practical it is here. A dramatic example of a completely impractical of tax will be, what was called, the federal Luxury Tax on new jewelry, that was enacted in 1990. The tax applied only too to the portion of the price that exceed $10,000 and only two items worn for adornment were subject to the tax. So we're trying to tax luxury that is used in a very particular way. Sounds like a very nice idea, but absolutely impractical. I'm going to quote an article by Scott Smellow (?) to give you an idea on how this didn't work out, "Under this tax, loose gems and repairs are taxed. Market value, after a major modification, is." So, you buy the gems on its own- no tax. If you repair something that you own, then you tax. Thus, you may be taxed if you have gems from your grandma's brooch putting in a new setting. But, you won't if you replace a $30,000 diamond lost for a ring - that's a repair (laughter). The cost of internal governal service of collecting the luxury good taxed and figuring out was it a repair, if it was purchase was so great and exceeded the revenue so largely collected from this tax, that the tax was repealed in 1993. So this experiment only lasted for three years.

Obviously no tax system is going to be costless to administer. As with everything else the trick is to find the best trade-off. In the case of the consumption tax, the trade-off is between the lower excess burden, but the increase administrative cost.

[Jim]

Okay, I'm giving the rejoinder on behalf of that. I think the consumption tax that Nathan leaves out is very intriguing. And from a fairness perspective, it's simply wrong to penalize people as individuals for savings, and from a society-wide perspective, we want people to invest. So, I think what's especially attractive about the consumption tax is the fact that it gives incentives to the wealthy to reinvest their money and not to engage in a sort of conspicuous consumption.

This takes us then to the taxation of wealth or the estate tax. I think there is a problem of the wealthy avoiding W-2's. I think the estimate is as many as 5,000 some families in America pay no tax precisely by avoiding the W-2, the way Nathan is talking about, so this is an issue. What is the estate tax? It is a tax on the current market value of all the assets in a dead person's estate, minus their debts, gifts, and bequests. This is also why it's called the "death tax". The death tax in America dates back to the 18th century. People generally associate the impulse to tax wealth based on the populous, and of course they were responsible for the 16th Amendment in 1913, which allowed the federal government to tax income. But in fact, the death tax was first raised by the Federalists during a threat of war with the British in 1797 and it was used again in the Civil War and the Spanish-American War. So I think we should call it the "war tax", is what it really is associated with.

In 2003, again as I mentioned, 1% of the total revenue of the government is raised by the state tax but also only 1% of the estates actually pay the tax. The ceiling has been gradually rising, as you perhaps know, on the estates that don't have to pay and now it's currently estates below $1.5 million dollars don't have to pay the tax.

In 2002, the Economic Growth and Tax Relief Reconciliation Act passed, I don't know if you remember that, but that's been gradually raising the level at which estates have to pay the tax and eventually the level disappears in 2010. So this is basically why it's scheduled to reappear in 2011, that's why the House voted last spring to repeal it forever. Right now, obviously, with Hurricane Katrina, the Senate is trying to figure out what they ought to do and it looks like the estate tax, may in fact, might not be repealed. I compare here to Dracula and so it looks like it's going to reappear and I want to make the case on why it should appear. I think we need to make a basic distinction between taxing inheritance and wealth, and taxing income. If we have any social contract in the society, it's the belief that as individuals, we are producers and we have the right to the income that we earn by the sweat of our brow. But that's not true for inheritance. Inheritance is separate in that regard.

I say those who inherit lack this proprietary claim to wealth and those who claim large sums of wealth, threaten to undermine the implicit ethical presupposition in the labor theory, the labor theory that you get to keep what you earn, which is inequality is acceptable in our democratic society in so far it is based on different levels of individual effort, so it's okay to have inequality, as long as it reflects the people actually doing work. Individuals whose wealth is tied not to labor but to trust funds that were perhaps set up by their parents or grandparents contribute to bad inequality. There's good inequality based on effort and bad inequality based on inheritance. And so that's my brief claim against the estate tax.

[Ruth]

Many people think the estate tax is necessary because of the unfairness and inconsistency of the income tax. So in other words I think the way other people look at it is these people are able to accumulate all this wealth because of the problems with income tax and we're finally going to get them when they die (laughter). We're finally going to, kind of, even out the playing field at death. I think that's one of the underlying, psychological things that we think about at this, the gift of the state tax.

The most common argument for the death tax is the rich investor who's been avoiding paying any tax or appreciate assets over his/her lifetime, should be taxed on these gains at death. Unfortunately, like our income tax, the estate tax has so many loopholes in it that it encourages the wealthy to avoid the tax by giving ultimately to their heirs, and again this is from McCaffrey, "the idea is to give early often in trust, if you do that, i you start giving away your estates early, or your potential estate early, often an in trust, the estate can be diminished by time of death that there is actually very little estate tax.

The result is we have an accumulation of second generation wealth, exactly what the estate tax was designed to prevent, and that's what Jim was talking about. If you look at the numbers, the concentration of wealth has gotten more, not less, since the estate tax has been put into place. So it actually hasn't done what it was set out to do, to solve that particular problem. According to McCaffrey, "the estate tax is a long term effect on the incentives to work and save." So again, it has problems that Diego talked about earlier with the income tax. Further, complicated transactions entered in to avoid the tax cost the government income revenue. If we have a fair and more consistent individual tax, this argument would be neutralized. The spending tax I described earlier is designed to replace both the income tax and the estate tax.

[Diego]

The same way we make an argument for a tax on personal income, we can also make an argument for taxing estates and gifts, and that's okay with me. My disagreement on this issue is with the fact that we don't' tax the receiver of the gift, we tax the giver of these gifts. After all, estates and gifts resend income to the receiver. So you have a personal income tax, why don't we include the personal income tax code, the income associated with the estates and gifts and this is what you pointed out before, the tax system is the result, is the child of the political system that we have. So a law in congress makes taxation of gifts and states a separate matter from the personal income tax. Of course if we start taxing the accumulation of wealth, when we're giving an incentive, is to the consumption wealth. So if we tax wealth, we're telling people that you should consume your wealth before you die. Is that really the message we want to send with the tax system? Probably not. But we'll leave that to congress (laughter). So to the extend of the state tax encourages rich people to spend more money when they're alive, the estate tax promotes inequality across the population. A different way of looking at the state tax would be to transform it into an excision tax, meaning that you get tax when you receive a gift, not when you make a gift or when you pass down an estate. This has complications as usual with elements of practicality. Because these are sort of lumpy increases in your income, when your Aunt dies and you get the 1966 Chevy (laughter), and your income goes up because you sell it then you will be taxed a large amount of money, which doesn't seem very fair. So perhaps this excision tax will be spread out over a lifetime's worth of acquisitions of estates and gifts. Again, how do we average this out over a lifetime? It's an element of practicality. We can also include extensions. We can grade these excision taxes according to the income of the receiver of the gift and that would make the tax a little bit more progressive than what would be at this point make that a little bit more fair.

[Jim]

Okay, well we've jabbered on long enough at this early hour, and now we're very interested to receive any questions you may have and we'll do our best to answer.

[Interviewer]

Professors Friedburg, Mendez-Carbajo, and Simeone take questions from the audience. The first question is, "What are your views on the AMT, the alternative minimum tax?"

[Ruth]

My response to that would be the AMT is again a way of trying to fix an income tax system that's broken and because what they're trying to do is say that you can avoid it, using everything else you can't avoid it, but we'll put in this alternative minimum tax, The consumption tax, the way I view it, would have no need for an AMT. I mean, it would just eliminate that totally. And the AMT, I'll have to admit, is a nasty tax because it seems to crop up in the most bizarre situations, really catches people unaware, so I would say that's really one of the terrible things about our current income tax and that's the only reason why the AMT was put in was because of the problems we have with the income tax, and they've been trying to fix the income tax since 1913. So, I mean, this is not a new problem. So it really has been a problem, really almost from the beginning.

[Interviewer]

"How would the proposed consumption tax effect retirement pensions?"

[Ruth]

I guess it would just follow. In other words, it is a progressive consumption tax, so people at the lower end would pay virtually no tax, so he puts in, this is simply put in for the sake of example. But perhaps a family of four would be exempt from any consumption tax on the first $20,000 of consumption. Any then he goes between $20,000 and $80,000, any consumption they would be taxed at 10%, and that would be net consumption. Just like how we need to understand that income taxes on taxable income, you know, when you look at your gross income on page one, and then you look at your taxable income, for many of us that's a huge difference after we can eliminate basically the consumption on certain items. And so he does have, that's where it's progressive. So, yes, if a person were have been saving a lot in pension income, as they consume it, they would be taxed on that. But the idea was that they would be able to save significantly more and have that savings grow. In other words, they keep trying to push that savings, that we can save tax-free, but you know let's say someone's in a 25% tax bracket, it's a lot better to save a dollar than it is to save 75 cents. I mean, the potential of growth is much greater. SO there would be a tax on pensions as it was consumed. Diego mentioned the problem with withholding, but frankly there's the same problem with our current income tax with withholding. It's that currently, people whose money is obtained other than a W-2, we all know if we work for someone, we can tell the employer we want so much withheld to cover. If we're working we have a similar ability to tell our employer to withhold and actually if we all look at our consumption habits, most of us have relatively consistent consumption habits. So, in fact, we can predict pretty well. And in fact under the current income tax, if someone sells an asset and has a $50,000 gain, it is their obligation to make sure that they have enough taxes paid at the end of the year to cover that excess income and if someone want to consume on some significant item in a given year, it's their obligation to see to with it, those taxes have also been paid. So really, consumption habits are not that variable for people, that part isn't really a problem.

[Jim]

But he raises a good point. You can see the AARP can jump on this and call it an age tax or something and it seems to me that it wouldn't be any different than an income tax.

[Ruth]

Well pension is a tax though. But lets say that your pensions, as you withdraw them, especially if you have it annuitized, you don't spend it all, you put it back in, you're not taxed on it.

[Interviewer]

How would the contemplated consumption tax affect state taxation?

[Ruth]

Well every state is different, so there are several states with progressive taxes and Illinois happenes to be flat taxed.

[Jim]

It's one of the issues with the consumption tax that if you get rid of the federal income tax, the states will have to refigure their entire system.

[Interviewer]

Don't value added taxes generate enormous amounts of paperwork?

[Diego]

Yeah the pile of paperwork that will be generated will be such a scheme. It will make it absolutely impractical and they will generate precisely that, an underground economy where it will start to trade services for services, goods for goods, or being paid under the table.

[Jim]

And that’s why she was distinguishing between a VAT or a sales tax and the consumption tax.

[Ruth]

Right. I mean the interesting thing is that if you look at the total tax obligations of no income tax states, very often they’re higher than the total tax obligations of a state with an income tax. So it’s kind of a misnomer when states, it’s true when they have no income tax, obviously states have to raise money they have obligations and so one way or the other you usually are going to pay something in those states.

[Diego]

The way I see taxes is as a monster on two legs: the one is politics and the other one is economics. If you take one out it’s just limping around.

[Interviewer]

To watch extent is a consumption tax or any other tax to reform practical realities?

[Diego]

It takes longer to figure out the politics aren’t working out. But we have to figure out both things.

[Jim]

One of the things we talked about as we were preparing for this was the miracle of the withholding tax from the perspective of the government and the fact that it’s so practical because if the people don't have the money in the first place, then, as far as they’re concerned, it’s easier to tax that. It’s when you have it and you have to give it up. Psychologists call it the “endowment effect”, same amount of money you might want to give up, but if you have it first, you won’t want to give that. And so that monster that you were talking about is enabled more by the withholding tax, which as Nathan pointed out is invented by Macy’s, as a kind of Christmas club approach to try to save, take money out of your check and you can say that it was the Macy’s people who really created that monster, not so much that 1913 income tax amendment.

[Interviewer]

Regardless of which tax reform is introduced, won't it become less effective as people adjust to the rules?

[Diego]

In all of these taxes in economics, it's called, "dynamic inconsistency". You design a tax system for a certain state of nature, you design a tax system that will work out in 2005. But five years from now, people have learned what are the loopholes, what are the lifestyles that would minimize your tax. So overtime, people evade the tax, overtime we tax out this tax and overtime the tax system that we created in 2005 will become completely useless. And the pays of reforms of the personal income tax, the managerial reforms, is not keeping up with the foolproof work studies, like patching a levi (laughter) Bad image (laughter). But you're trying to, like the VAT, the way to cheat on the VAT with all of these false invoices. So you set up a false corporation, and you start selling your bills to other people, so you can, at the end of the year, when you'll be creating your VAT, you're reporting, you're paying more VAT than you've received from other people. Therefore, at the end of the year you receive money from the government. So you can sit on that thing too. So none of these systems are going to be.

[Jim]

It seems to be a paradox because on the one hand, if you follow Diego's logic, you should be changing the tax rules regularly to avoid this accommodation, if you will. But on the other hand, when you change the rules, you create distortion. And Diego was also telling us the adjustment costs money too. It strikes me that we're sort of between a rock and a hard place in that regard.

[Diego]

The agenda and the opinion right now is to harmonize the fiscal policies. So if you get your income in Germany, you're legally entitled to move to Spain and spend your income there. But, you're going to be taxed differently because the personal income tax in Spain is different from the personal income tax in Germany. So now the struggle in the European Union is to have a harmonized tax system across the members of the European Union. But nonetheless, there is still Monaco. So if you don't like it then you just change your fiscal domicile to Monaco and then you're tax free. So there's always a loophole. How big, how obvious, that's the big question, but there's always a loophole.

[Interviewer]

What role might emerging technologies play in tax reform?

[Diego]

Those efficiencies hiring in the processing of the tax, so technology is going to allow us to collect the tax much faster and cheaply. But in terms of the inefficiencies of the deadweight loss of the tax burden, those technologies aren't going to help us with that. So some of our discussion here is that the burden of the tax, so well as discusses the burdens of practicality, technology is going to help us with practicality, but not with the tax burden.

[Jim]

So there's administrative costs and then there are these deadweight costs and then there are compliance costs.

[Diego]

According to this administration, nothing (laughter).

[Interviewer]

You've talked about the tax revenue side at every form, but what about the expenditure side and the overall size of the tax burden? Hasn't the burden expanded over time?

[Jim]

That's an interesting question. i'm sure political scientists, and I dont have the literature in front of me, have studied that issue of the expansion of the tax burden or the contraption of the tax burden.

[Diego]

We wanted to stay away from that. That's the other half of the question. As soon as you get the money, you spend it and part of the reasons why we have to collect so much money in these cumbersome ways is because we spend, you know, quite a lot of money. So we just left that part of the question out of our analysis (brief laughter), but that element too, there's no doubt about that.

[Interviewer]

How would we do no tax reform if no politics were involved?

[Jim]

There's moral disagreement. It's one of the great perplexing facts of human existence, but I would say that what you're proposing is precisely what we tried to do here- to hold off typical considerations, you just say what would be right from efficiency, fairness, and a practicality perspective. And the upshot is, then, from our discussion, the consumption tax - that's the one we thought was the best.

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